APPENDIX OF PETITIONER

In The

UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA

Norfolk Division

In the matter of

L & M REALTY CORPORATION,

Alleged Bankrupt

In Bankruptcy—No. 16,727

ORDER DISMISSING PETITION

This matter came on to be heard on the Petition for Review filed by Rena C. Leo, Executrix of the Estate of Louis S. Leo, Deceased, to the judgment of the Referee in Bankruptcy, to whom this cause has heretofore been referred, dismissing the Involuntary Bankruptcy herein filed, and upon the arguments of Counsel for the petitioner and Counsel for the alleged bankrupt, and it appearing to the Court that the judgment of the Referee in dismissing the Petition in Involuntary Bankruptcy is plainly right, it is therefore

ADJUDGED, ORDERED and DECREED, that the judgment of said Referee in dismissing said Petition is hereby sustained and said Petition is hereby dismissed, with prejudice, to which action of the Court the Petitioner, by her Counsel, duly excepted.

United States District Judge
/s/ WALTER E. HOFFMAN

Norfolk, Virginia
May 19, 1955

(Caption Omitted)

OPINION

On a review of the Referee's findings and conclusions in the above matter, the facts are not in dispute. The alleged bankrupt corporation was a "close" corporation of two stockholders who were its officers and directors, Dr. Louis S. Leo and Dr. Edward Myers. During the five year period prior to the filing of the involuntary petition herein, Leo and Myers advanced to the corporation the approximate sums of $17,000.00 and $18,000.00 respectively. It is admitted that these advances are genuine and not tainted with fraud as is so frequently the case in bankruptcy proceedings involving such corporations. Shortly prior to the filing of the involuntary petition the corporation was similarly indebted to two local banks, one in the sum of $5,000.00 the other in the amount of $9,000.00. Both bank notes carried the endorsements of Leo and Myers. Leo died prior to the filing of the petition and his estate is insolvent. After Leo's death and prior to the bankruptcy proceedings, Myers caused or permitted the banks to be paid in full from corporate funds, all of which was done within four months prior to the filing of the petition in involuntary bankruptcy. There are *no other creditors* involved.

The act of bankruptcy alleged is the contended "preference" in paying the banks within the period in question while the corporation was insolvent. While there are other defenses asserted in the answer, it is unnecessary to discuss the merits of same as the Referee's order dismissing the petition must be sustained.

Had a voluntary petition been filed prior to the payments to the banks, the creditors would have been as follows:

Bank No. 1—$5,000.00 (Note endorsed by Leo and Myers)

Bank No. 2—$9,000.00 (Note endorsed by Leo and Myers)

Estate of Louis S. Leo—$17,000.00 (more or less)

Dr. Edward Myers—$18,000.00 (more or less)

Since Leo's estate is insolvent, the rather obvious purpose of the bankruptcy is to permit the estate to share on a pro-rata basis, thereby leaving Myers the obligation to pay any existing deficit on any amount remaining due and owing the banks. It is a matter of common knowledge that banks do not care to seek payment from the estate of a deceased person when there is a living co-endorser who is perfectly solvent. All of the equities of the case are, therefore, with Myers, and he cannot be criticized for using corporate funds in paying obligations on which he and Leo were, in effect, jointly interested.

While the Referee did not have the benefit of the authorities submitted to this Court on review, and based his conclusion on the equitable principles as set forth in *Pepper v. Litton,* 308 U. S. 295, he arrived at the correct conclusion.

The petitioner is relying upon Title 11, U.S.C.A. § 96(a) (1), which states:

> "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an

antecedent debt, made, or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class*".

The essence of petitioner's argument is that the two banks herein are in the same class as the two creditors, Drs. Leo and Myers, and that the payment of the $14,000.00 to the two banks constituted a preference since it is alleged that the banks will receive a greater percentage than the two other creditors.

In answering this argument it is first necessary to determine whether or not a creditor who enjoys the assurance of a guarantor or surety of the debt is in a different class from a creditor who has no guarantor of the liability. There is authority that the two creditors are in different classes. *In re Harpke, et al* (7th CCA), 116 F. 295.

The *Harpke* case is discussed and repudiated after careful reasoning by the Eighth Circuit in *Swarts v. Fourth Nat. Bank of St. Louis,* 117 F. 1, 5. The court there reasons:

> "The test of classification is the percentage paid upon the claims out of the estate of the bankrupt."

This court adopts the position of the Eighth Circuit in the absence of any case in point in the Fourth Circuit. If, in the case at bar, there had been no payment to the banks (and the endorsers and creditors were not the same persons), each bank and each creditor would have shared proportionately in the proceeds of

the bankrupt's estate. Under such circumstances these four creditors would belong to the same class.

At this point, if the court were to apply the exact wording of Title 11, USCA § 96(a)(1), the petitioner's position would be correct. However, it is necessary to consider the effect of the statement in parentheses above wherein it is said "and the endorsers and creditors were not the same persons." If someone other than Leo and Myers were the endorsers on the banks' loans, Title 11, USCA § 96(a)(1) would be applicable and the payment to the banks by Myers would be a preference which the Bankruptcy Court could set aside. When, however, the sole stockholders in the corporation endorsed the notes to the banks, these stockholders contracted to see that the banks would be paid. Certainly these same stockholders cannot be permitted to come into this court and claim the right to be paid before the banks have recovered the entire amount owed to them. It is the duty of this court to see that equity prevails.

As said by Mr. Justice Douglas in *Pepper v. Litton*, 308 U. S. 295, 307:

> "As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy in the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty to do so is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder."

The equitable principle to be applied in this case may well be termed an estoppel. In contracting to guarantee payment to the banks of the amounts owed by the bankrupt corporation, the two stockholders are estopped from asserting any claim which would be in derogation of the rights of the banks in the assets of the alleged bankrupt.

This position is well stated in the opinion of Judge Sanborn in *Swarts v. Fourth Natl. Bank of St. Louis,* supra, at page 12:

> "The contract of Siegel & Bro. was that they would pay these notes if the bankrupt did not. By that contract they are estopped from collecting or receiving anything upon or on account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600 which is still due to it on the notes."

In the opinion of the court the cases of *Livingstone v. Heineman,* 120 F. 786, and *In re Star Spring Bed Company,* 257 F. 176, cited by petitioner are not applicable. The *Livingstone* case dealt solely with the question of whether or not the creditors were all of the same class. The case at bar has the added feature of part of the creditors also being guarantors of the debts due the other creditors. The *Star Spring Bed* case involved a preference arising out of the transfer of certain accounts in return for a note, where the value of the accounts exceeded the value of the note. In that case, also, all the creditors were of the same class and the guaranty of some of the creditors by the remaining creditors was not an element as it is in the case at bar.

To further strengthen the position taken by the Referee in this matter, there is no evidence before the

court in regard to the total paid-in capital of the bankrupt corporation. Frequently, in the case of a closely-held corporation, the stockholders, in lieu of subscribing to stock, attempt to put money into the operation of the corporation through the creation of a loan. In many cases this is permissible. In a bankruptcy case it is the duty of the court to look into all aspects of the "loan" in order to insure equitable distribution of the bankrupt's remaining assets.

As said by the Supreme Court in *Pepper v. Litton*, supra, at page 309:

> "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan."

This court believes that the "loans" of Leo and Myers may actually have been capital contributions rather than loans, in which case there would be no question as to the correctness of the Referee's decision. In view of the foregoing opinion, however, it is not necessary to decide whether or not Leo and Myers actually made loans or capital contributions to the bankrupt corporation.

An order will be prepared by counsel for the alleged bankrupt sustaining the Referee's dismissal of the petition herein in conformity with this opinion.

(SGD) WALTER E. HOFFMAN
United States District Judge

Norfolk, Virginia
May 5, 1955

(Caption Omitted)

CERTIFICATE OF REVIEW

To: The Honorable Walter E. Hoffman, Judge of said Court:

The undersigned Referee in Bankruptcy respectfully submits his certificate of review upon a petition filed on November 24, 1954, to review an order entered by the Referee on November 16, 1954.

STATEMENT OF THE CASE

This proceeding was initiated in this Court by the petition of Rena C. Leo, Executrix of the Estate of Louis S. Leo, deceased, seeking the involuntary adjudication in bankruptcy of L & M Realty Corporation. The corporation filed an answer setting up various defenses. The matter was heard before the Referee after due reference, and the order under review was subsequently entered, dismissing the petition, with leave to the petitioner to amend within twenty days.

QUESTION PRESENTED

The sole question presented on this review is whether the alleged bankrupt, on August 12, 1954, within four months of the filing of the petition, and while insolvent, committed an act of bankruptcy by making preferential payments to the Seaboard Citizens National Bank and National Bank of Commerce, both of Norfolk, two of its creditors.

There is another question possible in this review, in that the Referee declined to pass on other defenses raised by the alleged bankrupt, but if the dismissal of the petitioner be affirmed, it will not be necessary to reach the other questions.

EVIDENCE PRESENTED

There was no conflict in the evidence, and all matters of fact pertaining to the question in issue were stipulated, as shown in the transcript of the proceedings filed with this certificate.

It was *stipulated* that on August 12, 1954, *within four months* of the filing of the involuntary petition of bankruptcy and *while insolvent,* the L & M Realty Corporation paid to National Bank of Commerce the sum of $9,000.00 and to Seaboard Citizens National Bank the sum of $5,000.00, which payments satisfied in full the existing obligation of the alleged bankrupt corporation to the two banks. It was also stipulated that the respective obligations of the alleged bankrupt to the two banks were guaranteed by the personal endorsement of the petitioner's decedent and the other principal owner of the alleged bankrupt, Dr. Edward Myers.

It was also stipulated for the purpose of passing on the question of whether a preference had been made, that *petitioner's decedent was a creditor* of the corporation in the amount of $17,501.85, but this stipulation did not extend to other possible defenses of the alleged bankrupt. It was also stipulated that the corporation had no *other creditors except the two banks and the two principals,* Dr. Leo and Dr. Myers, and this stipulation was also limited in its operation to the particular question of whether or not a preference had been effected.

FINDINGS OF FACT

Since the evidence was all stipulated, the statement of the evidence is adopted as the finding of fact of the Referee.

CONCLUSIONS OF LAW

It is concluded by the Referee that the payments of August 12, 1954, do not constitute preferences, because no creditor has thereby obtained a greater percentage of his debt than any other creditors of the same class. The personal endorsement of the obligations of the corporation to the banks by the two other creditors, in effect, created two classes of creditors: (1) the banks, which gained a preferential status; and (2) the guaranteeing creditors, who thereby subordinated their claims.

If, on August 12, 1954, all the assets of the alleged bankrupt had been ratably distributed to all four creditors, still the two banks would have been entitled to make the other two creditors pay over in full the dividend received from the corporation, since it held their personal endorsement of the obligations and was

equitably entitled to payment in full from the corporation, before either of the other two creditors were entitled to be paid any percentage at all.

A preference, as an act of bankruptcy, is defined by the Bankruptcy Act by reference in Section 60a. of the Act Section 60a. reads in part as follows:

". . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class. . .*" The Act does not define what is a "class" of creditors, nor has any case been found in point with the one under review. However, it is obvious that creditors of the same class are those entitled to be paid in the distribution of the estate in the same order of priority.

Here the banks are undoubtedly entitled, under the peculiar facts of this case, to be paid in a higher order of priority than the endorsing creditors, since the endorsers are the sole stockholders of the alleged bankrupt, and the rights of no other creditors are involved. It is well established that courts of bankruptcy are essentially courts of equity. As is said in *Pepper v. Litton,* 308 U. S. 295, S. Ct. 238, 84 L. Ed. 281, in Headnote No. 2:

> "Courts of bankruptcy, in passing upon the validity and priority of claims, exercise equity powers and have not only the power but the duty to disallow or subordinate claims if equity and fairness so require. That power and duty are especially clear where the claim seeking allowance accrues to the benefit of an officer, director or stockholder of the bankrupt."

It is clear under the doctrine of *Pepper v. Litton* that the claims of the stockholders must be subordinated

by this court to the claims of the banks, when the stockholders have personally guaranteed payment of the claims to the banks.

Put another way, petitioner's decedent is estopped to claim that the banks should not be paid in full ahead of himself. By his endorsement, he said, in effect, to the banks: "If the corporation cannot pay you, I will pay you." In a court of equity powers, he cannot be heard to take a different position by way of complaint that the banks have been preferred over him in receiving payment of the very obligation he endorsed.

The petition in involuntary bankruptcy cannot, therefore, be maintained by Dr. Leo's executrix, and the Fourth Defense of the alleged bankrupt should be sustained.

Submitted herewith are the involuntary petition in bankruptcy, answer of the alleged bankrupt, reporter's transcript, and petition for review.

Respectfully submitted,

William C. Worthington,
Referee in Bankruptcy

Norfolk, Virginia
December 30, 1954

(Caption Omitted)

ORDER

This matter came on to be heard on the 4th day of November, 1954, by the undersigned Referee in Bankruptcy upon the Petition in involuntary bankruptcy of

Rena C. Leo, Executrix of the Estate of Dr. Louis S. Leo, deceased, upon the answer of the alleged bankrupt herein filed, upon the stipulations of counsel for both the Petitioner and the Alleged Bankrupt with reference to the Fourth Defense contained in said Answer.

And it appearing to the Court that the Fourth Defense should be sustained,

IT IS, THEREFORE, ORDERED That the Petition herein filed be, and the same hereby is, dismissed,

But the Petitioner is hereby granted twenty (20) days from November 4, 1954, in which to file an amended petition herein, to which action of the Court the Petitioner duly excepted,

And the Alleged Bankruptcy duly excepted to the action of the Court in refusing to hear evidence on the Alleged Bankrupt's Third Defense, Fifth Defense, Sixth Defense, Seventh Defense, Eighth Defense, Ninth Defense and Tenth Defense.

/s/ WILLIAM C. WORTHINGTON
Referee in Bankruptcy

Dated at Norfolk, Virginia
November 16, 1954

/s/ WILLIAM C. WORTHINGTON
A copy teste:

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Referee in Bankruptcy

Office - Supreme Court, U.S.
FILED
JAN 9 1956
HAROLD B. WILLEY, Clerk

No. 617

APPENDIX OF APPELLANT

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Norfolk Division

In the matter of
L & M Realty Corporation,
Alleged Bankrupt

In Bankruptcy

No. 16,727

ORDER DISMISSING PETITION

This matter came on to be heard on the Petition for Review filed by Rena C. Leo, Executrix of the Estate of Louis S. Leo, Deceased, to the judgment of the Referee in Bankruptcy, to whom this cause has heretofore been referred, dismissing the Involuntary Bankruptcy herein filed, and upon the arguments of Counsel for the petitioner and Counsel for the alleged bankrupt, and it appearing to the Court that the judgment of the Referee in dismissing the Petition in Involuntary Bankruptcy is plainly right, it is therefore

ADJUDGED, ORDERED and DECREED, that the judgment of said Referee in dismissing said Petition is hereby sustained and said Petition is hereby dismissed, with prejudice, to which action of the Court the Petitioner, by her Counsel, duly excepted.

United States District Judge
/s/ WALTER E. HOFFMAN

Norfolk, Virginia
May 19, 1955

[Caption Omitted]

OPINION

On a review of the Referee's findings and conclusions in the above matter, the facts are not in dispute. The alleged bankrupt corporation was a "close" corporation of two stockholders who were its officers and directors, Dr. Louis S. Leo and Dr. Edward Myers. During the five year period prior to the filing of the involuntary petition herein, Leo and Myers advanced to the corporation the approximate sums of $17,000.00 and $18,000.00 respectively. It is admitted that these advances are genuine and not tainted with fraud as is so frequently the case in bankruptcy proceedings involving such corporations. Shortly prior to the filing of the involuntary petition the corporation was similarly indebted to two local banks, one in the sum of $5,000.00 the other in the amount of $9,000.00. Both bank notes carried the endorsements of Leo and Myers. Leo died prior to the filing of the petition and his estate is insolvent. After Leo's death and prior to the bankruptcy proceedings, Myers caused or permitted the banks to be paid in full from corporate funds, all of which was done within four months prior to the filing of the petition in involuntary bankruptcy. There are *no other creditors* involved.

The act of bankruptcy alleged is the contended "preference" in paying the banks within the period in question while the corporation was insolvent. While there are other defenses asserted in the answer, it is unnecessary to discuss the merits of same as the Referee's order dismissing the petition must be sustained.

Had a voluntary petition been filed prior to the payments to the banks, the creditors would have been as follows:

Bank No. 1—$5,000.00 (Note endorsed by Leo and Myers)
Bank No. 2—$9,000.00 (Note endorsed by Leo and Myers)
Estate of Louis S. Leo—$17,000.00 (more or less)
Dr. Edward Myers—$18,000.00 (more or less)

Since Leo's estate is insolvent, the rather obvious purpose of the bankruptcy is to permit the estate to share on a pro-rata basis, thereby leaving Myers the obligation to pay any existing deficit on any amount remaining due and owing the banks. It is a matter of common knowledge that banks do not care to seek payment from the estate of a deceased person when there is a living co-endorser who is perfectly solvent. All of the equities of the case are, therefore, with Myers, and he cannot be criticized for using corporate funds in paying obligations on which he and Leo were, in effect, jointly interested.

While the Referee did not have the benefit of the authorities submitted to this Court on review, and based his conclusion on the equitable principles as set forth in *Pepper* v. *Litton*, 308 U. S. 295, he arrived at the correct conclusion.

The petitioner is relying upon Title 11, U.S.C.A. §96(a)(1), which states:

> "A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made, or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class*".

The essence of petitioner's argument is that the two banks herein are in the same class as the two creditors, Drs. Leo and Myers, and that the payment of the $14,000.00 to the two banks constituted a preference since it is alleged that the banks will receive a greater percentage than the two other creditors.

In answering this argument it is first necessary to determine whether or not a creditor who enjoys the assurance of a guarantor or surety of the debt is in a different class from a creditor who has no guarantor of the liability. There is authority that the two creditors are in different classes. *In re Harpke, et al* (7th CCA), 116 F. 295.

The *Harpke* case is discussed and repudiated after careful reasoning by the Eighth Circuit in *Swarts* v. *Fourth Nat. Bank of St. Louis,* 117 F. 1, 5. The court there reasons:

> "The test of classification is the percentage paid upon the claims out of the estate of the bankrupt".

This court adopts the position of the Eighth Circuit in the absence of any case in point in the Fourth Circuit. If, in the case at bar, there had been no payment to the banks (and the endorsers and creditors were not the same persons), each bank and each creditor would have shared proportionately in the proceeds of the bankrupt's estate. Under such circumstances these four creditors would belong to the same class.

At this point, if the court were to apply the exact wording of Title 11, USCA §96(a)(1), the petitioner's position would be correct. However, it is necessary to consider the effect of the statement in parentheses above wherein it is said "and the endorsers and creditors were not the same persons". If someone other than Leo and Myers were the endorsers on the banks' loans, Title 11, USCA §96(a)(1) would be applicable and the

payment to the banks by Myers would be a preference which the Bankruptcy Court could set aside. When, however, the sole stockholders in the corporation endorsed the notes to the banks, these stockholders contracted to see that the banks would be paid. Certainly these same stockholders cannot be permitted to come into this court and claim the right to be paid before the banks have recovered the entire amount owed to them. It is the duty of this court to see that equity prevails.

As said by Mr. Justice Douglas in *Pepper* v. *Litton,* 308 U.S. 295, 307:

> "As we have said, the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the fiduciary responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty to do so is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder".

The equitable principle to be applied in this case may well be termed an estoppel. In contracting to guarantee payment to the banks of the amounts owed by the bankrupt corporation, the two stockholders are estopped from asserting any claim which would be in derogation of the rights of the banks in the assets of the alleged bankrupt.

This position is well stated in the opinion of Judge Sanborn in *Swarts* v. *Fourth Natl. Bank of St. Louis,* supra, at page 12:

> "The contract of Siegel & Bro. was that they would

> pay these notes if the bankrupt did not. By that contract they are estopped from collecting or receiving anything upon or on account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600 which is still due to it on the notes".

In the opinion of the court the cases of *Livingstone* v. *Heineman,* 120 F. 786, and *In re Star Spring Bed Company,* 257 F. 176, cited by petitioner are not applicable. The *Livingstone* case dealt solely with the question of whether or not the creditors were all of the same class. The case at bar has the added feature of part of the creditors also being guarantors of the debts due the other creditors. The *Star Spring Bed* case involved a preference arising out of the transfer of certain accounts in return for a note, where the value of the accounts exceeded the value of the note. In that case, also, all the creditors were of the same class and the guaranty of some of the creditors by the remaining creditors was not an element as it is in the case at bar.

To further strengthen the position taken by the Referee in this matter, there is no evidence before the court in regard to the total paid-in capital of the bankrupt corporation. Frequently, in the case of a closely-held corporation, the stockholders, in lieu of subscribing to stock, attempt to put money into the operation of the corporation through the creation of a loan. In many cases this is permissible. In a bankruptcy case it is the duty of the court to look into all aspects of the "loan" in order to insure equitable distribution of the bankrupt's remaining assets.

As said by the Supreme Court in *Pepper* v. *Litton,* supra, at page 309:

> "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated in effect as capital contributions by the stockholder not only in the foregoing types of situations but also where the paid-in capital is purely nominal, the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan".

This court believes that the "loans" of Leo and Myers may actually have been capital contributions rather than loans, in which case there would be no question as to the correctness of the Referee's decision. In view of the foregoing opinion, however, it is not necessary to decide whether or not Leo and Myers actually made loans or capital contributions to the bankrupt corporation.

An order will be prepared by counsel for the alleged bankrupt sustaining the Referee's dismissal of the petition herein in conformity with this opinion.

(SGD) WALTER E. HOFFMAN
United States District Judge

Norfolk, Virginia
May 5, 1955

[Caption Omitted]

CERTIFICATE OF REVIEW

To: The Honorable Walter E. Hoffman, Judge of said Court:

The undersigned Referee in Bankruptcy respectfully submits his certificate of review upon a petition filed on November 24, 1954, to review an order entered by the Referee on November 16, 1954.

STATEMENT OF THE CASE

This proceeding was initiated in this Court by the petition of Rena C. Leo, Executrix of the Estate of Louis S. Leo, deceased, seeking the involuntary adjudication in bankruptcy of L & M Realty Corporation. The corporation filed an answer setting up various defenses. The matter was heard before the Referee after due reference, and the order under review was subsequently entered, dismissing the petition, with leave to the petitioner to amend within twenty days.

QUESTION PRESENTED

The sole question presented on this review is whether the alleged bankrupt, on August 12, 1954, within four months of the filing of the petition, and while insolvent, committed an act of bankruptcy by making preferential payments to the Seaboard Citizens National Bank and National Bank of Commerce, both of Norfolk, two of its creditors.

There is another question possible in this review, in that the Referee declined to pass on other defenses raised by the alleged bankrupt, but if the dismissal of the petitioner be affirmed, it will not be necessary to reach the other questions.

EVIDENCE PRESENTED

There was no conflict in the evidence, and all matters of fact

pertaining to the question in issue were stipulated, as shown in the transcript of the proceedings filed with this certificate.

It was *stipulated* that on August 12, 1954, *within four months* of the filing of the involuntary petition of bankruptcy and *while insolvent,* the L & M Realty Corporation paid to National Bank of Commerce the sum of $9,000.00 and to Seaboard Citizens National Bank the sum of $5,000.00, which payments satisfied in full the existing obligation of the alleged bankrupt corporation to the two banks. It was also stipulated that the respective obligations of the alleged bankrupt to the two banks were guaranteed by the personal endorsement of the petitioner's decedent and the other principal owner of the alleged bankrupt, Dr. Edward Myers.

It was also stipulated for the purpose of passing on the question of whether a preference had been made, that *petitioner's decedent was a* creditor of the corporation in the amount of $17,501.85, but this stipulation did not extend to other possible defenses of the alleged bankrupt. It was also stipulated that the corporation had no *other creditors except the two banks and the two principals,* Dr. Leo and Dr. Myers, and this stipulation was also limited in its operation to the particular question of whether or not a preference had been effected.

FINDINGS OF FACT

Since the evidence was all stipulated, the statement of the evidence is adopted as the finding of fact of the Referee.

CONCLUSIONS OF LAW

It is concluded by the Referee that the payments of August

12, 1954, do not constitute preferences, because no creditor has thereby obtained a greater percentage of his debt than any other creditors of the same class. The personal endorsement of the obligations of the corporation to the banks by the two other creditors, in effect, created two classes of creditors: (1) the banks, which gained a preferential status; and (2) the guaranteeing creditors, who thereby subordinated their claims.

If, on August 12, 1954, all the assets of the alleged bankrupt had been ratably distributed to all four creditors, still the two banks would have been entitled to make the other two creditors pay over in full the dividend received from the corporation, since it held their personal endorsement of the obligations and was equitably entitled to payment in full from the corporation, before either of the other two creditors were entitled to be paid any percentage at all.

A preference, as an act of bankruptcy, is defined by the Bankruptcy Act by reference in Section 60a. of the Act Section 60a. reads in part as follows:

". . . the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the *same class* . . ." The Act does not define what is a "class" of creditors, nor has any case been found in point with the one under review. However, it is obvious that creditors of the same class are those entitled to be paid in the distribution of the estate in the same order of priority.

Here the banks are undoubtedly entitled, under the peculiar facts of this case, to be paid in a higher order of priority than the endorsing creditors, since the endorsers are the sole stockholders of the alleged bankrupt, and the rights of no other creditors are involved. It is well established that courts of bankruptcy are essentially courts of equity. As is said in *Pepper* v.

Litton, 308 U.S. 295, S.Ct. 238, 84 L.Ed. 281, in Headnote No. 2:

> "Courts of bankruptcy, in passing upon the validity and priority of claims, exercise equity powers and have not only the power but the duty to disallow or subordinate claims if equity and fairness so require. That power and duty are especially clear where the claim seeking allowance accrues to the benefit of an officer, director or stockholder of the bankrupt."

It is clear under the doctrine of *Pepper* v. *Litton* that the claims of the stockholders must be subordinated by this court to the claims of the banks, when the stockholders have personally guaranteed payment of the claims to the banks.

Put another way, petitioner's decedent is estopped to claim that the banks should not be paid in full ahead of himself. By his endorsement, he said, in effect, to the banks: "If the corporation cannot pay you, I will pay you." In a court of equity powers, he cannot be heard to take a different position by way of complaint that the banks have been preferred over him in receiving payment of the very obligation he endorsed.

The petition in involuntary bankruptcy cannot, therefore, be maintained by Dr. Leo's executrix, and the Fourth Defense of the alleged bankrupt should be sustained.

Submitted herewith are the involuntary petition in bankruptcy, answer of the alleged bankrupt, reporter's transcript, and petition for review.

Respectfully submitted,

William C. Worthington
Referee in Bankruptcy.

Norfolk, Virginia
December 30, 1954.

[Caption Omitted]

ORDER

This matter came on to be heard on the 4th day of November, 1954, by the undersigned Referee in Bankruptcy upon the Petition in involuntary bankruptcy of Rena C. Leo, Executrix of the Estate of Dr. Louis S. Leo, deceased, upon the Answer of the Alleged Bankrupt herein filed, and upon the stipulations of counsel for both the Petitioner and the Alleged Bankrupt with reference to the Fourth Defense contained in said Answer.

And it appearing to the Court that the Fourth Defense should be sustained,

IT IS, THEREFORE, ORDERED That the Petition herein filed be, and the same hereby is, dismissed,

But the Petitioner is hereby granted twenty (20) days from November 4, 1954, in which to file an amended petition herein, to which action of the Court the Petitioner duly excepted,

And the Alleged Bankruptcy duly excepted to the action

of the Court in refusing to hear evidence on the Alleged Bankrupt's Third Defense, Fifth Defense, Sixth Defense, Seventh Defense, Eighth Defense, Ninth Defense and Tenth Defense.

/s/ WILLIAM C. WORTHINGTON
Referee in Bankruptcy

Dated at Norfolk, Virginia
November 16, 1954.

/s/ William C. Worthington
A copy teste:

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Referee in Bankruptcy.